Legislative Audit Division

State of Montana

Report to the Legislature

March 2001

Financial-Compliance Audit

For the Fiscal Year Ended June 30, 2000

Montana State Fund

We performed a financial-compliance audit of the Montana State Fund for the fiscal year ended June 30, 2000. This report contains the audited financial statements and accompanying notes for fiscal year 1999-2000, with comparative fiscal year 1998-1999 amounts. We issued an unqualified opinion on the financial statements. The opinion means the reader may rely on the financial statement information presented.

The current report contains one recommendation related to administrative cost limitations. The prior report contained no recommendations.

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 1999, was issued on March 30, 2000. The Single Audit Report for the two fiscal years ended June 30, 2001, will be issued by March 31, 2002. Copies of the Single Audit Report, when available, can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel
Tori Hunthausen, IT & Operations Manager

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
James Gillett, Financial-Compliance Audit

March 2001

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Montana State Fund for one fiscal year ending June 30, 2000. The report contains an unqualified opinion on the department's financial statements. Included in this report is one recommendation to State Fund concerning the administrative cost limit. State Fund's written response to the audit recommendation is included in the audit report.

We thank the President and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

Scott A. Seacat
Legislative Auditor

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Phone (406)444-3122 FAX (406)444-9784 E-Mail lad@state.mt.us

Legislative Audit Division

Financial-Compliance Audit
For the Fiscal Year Ended June 30, 2000

Montana State Fund

Members of the audit staff involved in this audit were Pearl M. Allen, Chris G. Darragh, John Fine, Emlyn Neuman-Javornik and Sonia Powell.

Table of Contents

Appointed and Administrative Officials

Montana State Fund

Carl Swanson	President/CEO
Mark Barry	Senior Vice President, Administration and Finance
Jim McCluskey	Vice President, Claims
Lanny Hubbard	Vice President, Underwriting and Marketing
Nancy Butler	Vice President, Legal and General Counsel
Joanne Shydian	Vice President, Human Resources and Communications
Connie Brooks	Vice President, Information Technology

State Fund Board of Directors

		Term Ending
Jim Brouelette, Chairman	Missoula	4/2001
Herb Leuprecht, Vice Chairman	Butte	4/2001
Brian Donahue	Billings	4/2001
Tom Horn	Cohagen	4/2003
Lorretta Lynde	Helena	4/2003
Jack Morgenstern	Lewistown	4/2001
Wendy J. Susott	Missoula	1/2003

For additional information concerning the Montana State Fund contact Carl Swanson, President/CEO, at:

5 South Last Chance Gulch
Helena MT 59601
(406) 444-6501

Montana State Fund

This financial-compliance audit report contains the results of our audit of the Montana State Fund for the fiscal year ended June 30, 2000. We issued an unqualified opinion on the financial statements of the fund for fiscal year 1999-00. This means the reader may rely on the information presented and the supporting accounting records. The report contains one recommendation for improving compliance with state law.

The prior report contained no recommendations.

The listing below summarizes the recommendation contained in this report.

Recommendation #1

We recommend the Montana State Fund seek legislation to remove the ambiguities in section 39-71-2363, MCA, with regard to administrative expense limitation. . . . . Page 5

State Fund Response: Partially concur. See page B-3.

Introduction and Scope

We performed a financial-compliance audit of the Montana State Fund (State Fund) for the fiscal year ended June 30, 2000. The objectives of the audit were to:

1. Review State Fund's control systems and make recommendations, if necessary, for the improvement of management and internal controls of the department.

2. Determine if the department complied with applicable state and federal laws and regulations.

3. Determine if the State Fund's financial statements present fairly, in accordance with state accounting policy, the results of operations for the audit period.

This report contains one recommendation to the State Fund. Areas of concern deemed not to have a significant effect on the successful operation of State Fund's programs are not specifically included in the report, but have been discussed with management. In accordance with section 5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendation in this report.

Background

The Montana State Fund was established to provide an "always available coverage option" for employers who must obtain mandatory workers' compensation insurance. In addition, Montana State Fund also provides workers with wage supplements and medical benefits when they have suffered a work-related injury. These benefits are to be provided at a reasonable cost to the employer. The State Fund is governed by a seven-member board of directors who are appointed to four-year terms by the Governor. The board of directors must include at least four members who represent policyholders of the State Fund, at least four members who are representatives of private industry, and one member may be a licensed insurance producer. Currently, the State Fund provides 23,481 employers with workers compensation insurance under the New Fund.

Introduction

The State Fund reorganized its operational structure on November 9, 2000, to a team environment. The new structure includes four functional teams. These teams are the corporate support team, the general counsel, the operations team, and the operations support team. The corporate support function includes accounting, actuarial, human resource, communication, document processing, information technology, and special project responsibilities. The general counsel function is responsible for rule making, contracted services, general legal and business inquiries, general policy inquiries, human resource issues, and bankruptcy court proceedings. The operations function is responsible for servicing policyholders needs. This function is comprised of six teams responsible for policy underwriting, policy maintenance, loss control, claim management, premium verification, premium accounting, and customer service. The operations support function provides expert support in underwriting, accident prevention, and claims. This function also includes legal services, attorneys, and business analysis.

Administrative Cost Limit

Prior to 1997, section 39-71-2363, MCA, limited the entire expense of administering the State Fund to 15 percent of the earned annual premium of the prior fiscal year. In 1997, the legislature enacted Chapter 276, Laws of 1997, which modified this section and permits the State Fund board of directors to approve administrative expenses in excess of 15 percent of the earned annual premium providing the excess did not exceed one-half the investment income earned in the prior fiscal year.

In fiscal year 1997-98, the state of Montana implemented Governmental Accounting Standards Board Statement 31 (GASB 31). Under GASB 31, investment income includes changes in the fair value of investments. GASB 31 states, "When identified separately as an element of investment income, the change in fair value of investments should be captioned *net increase (decrease) in the fair value of investments.*" State Fund complies with state laws and reports its operations in accordance with generally accepted accounting principles, including following GASB 31 when reporting investment income on its financial statements.

The implementation of GASB 31 changed the meaning of investment income for governmental financial reporting purposes. Since state law does not define the term "investment income earned" and governmental accounting standards classify the change in fair value of investments as revenue, it appears that the meaning of the term investment income earned has changed since the passage of Chapter 276, Laws of 1997. The differing definitions of investment income generate differing administrative expense limits. Applying the GASB 31 definition causes wide fluctuations in the limit based on changes in the value of the State Fund investment portfolio. The following table illustrates the impact on the expense limit for fiscal year 1999-2000 of applying different definitions of investment income.

Table 1
Impact of Investment Income on Administrative Expense Limit

	Limit With Change in Fair Value of Investments in Income	Limit Without Change in Fair Value of Investments Included in Income
15% of Net Premium	$10,599,000	$10,599,000
50% of Investment income	12,049,000	19,314,000
Administrative Expense Limit	$22,648,000	$29,913,000

Source: Compiled by the Legislative Audit Division.

State Fund complied with section 39-71-2363, MCA, using either interpretation of the administrative expense limit. State Fund management has consistently interpreted investment income earned as interest earned on investments during the fiscal year added to gains or losses realized from the sale of investments during the fiscal year. Since State Fund's investment plan involves maintaining a ladder of maturities of fixed income securities and holding these investments to maturity, gains and losses have little impact on investment income earned as defined by State Fund. The fiscal notes prepared by the Office of Budget and Program Planning for Chapter 276, Laws of 1997, were consistent with this interpretation.

The State Fund consists of two insurance pools: New Fund claims for accidents occurring on or after July 1, 1990 and Old Fund claims for accidents which occurred prior to July 1, 1990. Section 39-71-2363, MCA, allows that the entire expense of administering the State Fund to be included in the administrative expense calculation. Some analyses prepared by State Fund management have regarded the law as a New Fund administrative expense limitation. As a result, neither the Old Fund investment income nor

the Old Fund administrative expenses were included in the analyses which we believe is allowed by section 39-71-2363, MCA.

Under section 39-71-2315, MCA, the management and control of the Montana State Fund is vested solely in its board of directors. For the board to fulfill its responsibilities, the limits on its authority to incur administrative costs must be clear. Current application of the administrative expense limit from section 39-71-2363, MCA, has generated differences in interpretation as to which entity the limit applies and as to the meaning of investment income earned. Montana State Fund can clarify its administrative cost management limits by seeking changes that remove ambiguity from this law.

Recommendation #1
We recommend the Montana State Fund seek legislation to remove the ambiguities in section 39-71-2363, MCA, with regard to administrative expense limitation.

Independent Auditor's Report & Fund Financial Statements

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel
Tori Hunthausen, IT & Operations Manager

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Balance Sheets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2000 and 1999 and the related Statements of Operations and Changes in Fund Equity, New Fund and Old Fund, and Statements of Cash Flows, New Fund and Old Fund, for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2000 and 1999, and the results of its operations and of its cash flows for the two fiscal years then ended, in conformity with generally accepted accounting principles.

Respectfully submitted,

James Gillett

James Gillett, CPA
Deputy Legislative Auditor

October 30, 2000

Room 160, State Capitol, PO Box 201705 Helena MT 59620-1705
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MONTANA STATE FUND - NEW FUND
BALANCE SHEETS
The State Fund is a component unit of the State of Montana
AS OF JUNE 30

ASSETS

	(in thousands) 2000	(in thousands) 1999
Cash in Treasury	$ 2,436	$ 446
Short-Term Investment Pool (Note 1)	27,517	25,451
Premium Receivable (Note 1)	14,948	14,995
Allowance for Doubtful Accounts (Note 1)	(394)	(395)
Due From Other Funds (Notes 1 and 5)	491	1,797
Interest Receivable (Note 1)	6,989	6,494
Short-Term Notes & Loans Receivable	74	90
Long-Term Securities (Notes 1 and 2)	412,432	422,933
Cash Collateral - Securities on Loan (Note 1)	100,180	91,728
Supplies Inventory	27	33
Equipment (Note 1)	2,658	2,575
Accumulated Depreciation	(1,466)	(1,522)
Deferred Acquisition Costs	171	-
Intangible Assets	6,201	6,992
Property Held in Trust	281	281
Other Assets	84	479
Total Assets	$ 572,629	$ 572,377

LIABILITIES AND FUND EQUITY

	2000	1999
Liabilities		
Estimated Claims Payable (Note 4)	$ 314,900	$ 303,500
Liability for Securities on Loan	100,180	91,728
Deferred Revenue	14,593	19,315
Security Deposits (Note 1)	994	418
Accounts Payable	1,572	1,417
Due to Other Funds	1,199	10,792
Compensated Absences (Note 8)	927	844
Total Liabilities	434,365	428,014
Fund Equity		
Unrestricted Fund Balance	138,264	144,363
Total Liabilities and Fund Equity	$ 572,629	$ 572,377

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - NEW FUND
STATEMENTS OF OPERATIONS AND CHANGES IN FUND EQUITY
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
NET PREMIUM	$ 70,657	$ 70,170
CLAIMS EXPENSES		
Compensation Benefits Paid	27,403	28,168
Medical Benefits Paid	27,927	25,486
Allocated Loss Adjustment Expenses	1,704	2,306
Change in Estimated Claims Liability	11,400	(7,187)
Total claims expenses	68,434	48,773
UNDERWRITING EXPENSES		
Personal services	9,988	9,291
Contractual and other services	4,891	3,322
Materials and supplies	344	670
Depreciation	288	253
Amortization	987	345
Utilities and rent	160	155
Communications	834	495
Travel	155	119
Repairs and maintenance	502	396
Bad debts	(147)	490
Other underwriting expenses	2,505	1,822
Less Deferred acquisition costs	(171)	-
Operating Expenses	20,336	17,358
UNDERWRITING GAIN/(LOSS)	(18,113)	4,039
INVESTMENT INCOME (EXPENSE)		
Dividend Expense	(6,951)	(9,992)
Investment Income	29,905	29,661
Net Increase/(Decrease) in Fair Value of Investments (Note 2)	(11,118)	(11,850)
Securities Lending Income (Note 1)	5,371	4,944
Securities Lending Expense (Note 1)	(5,207)	(4,734)
Other Income	50	44
Investment income, net	12,050	8,073
NONOPERATING EXPENSE		
Gain/(Loss) on Sale of Assets	(36)	(1)
Operating Transfers Out (Note 6)	-	(10,000)
Total nonoperating expense	(36)	(10,001)
NET INCOME (LOSS)	(6,099)	2,111
Prior Year Adjustment	-	5
Prior Year End Fund Equity	144,363	142,247
END OF PERIOD FUND EQUITY	$ 138,264	$ 144,363

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - NEW FUND
STATEMENTS OF CASH FLOWS
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for Premiums	$ 68,072	$ 69,267
Payments to Suppliers for Goods and Services	(6,998)	(6,410)
Payments to Employees	(9,809)	(9,017)
Cash Payments for Claims	(56,640)	(56,307)
Other Operating Revenues	48	42
Other Operating Expenditures	(9,213)	(9,992)
Net Cash Provided by (Used in) Operating Activities	(14,540)	(12,417)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Return on Contributed Capital	-	-
Operating Transfer Out	(10,000)	-
Residual Equity Transfer	-	-
Net Cash Provided by (Used in) Noncapital Financing Activities	(10,000)	-
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of Fixed Assets	(554)	(771)
Proceeds from Sale of Fixed Assets	46	7
Net Cash Used for Capital and Related Financing Activities	(508)	(764)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Investments	(65,585)	(65,449)
Proceeds from Sales or Maturities of Investments	58,435	55,376
Security Lending Income	5,232	5,043
Security Lending Cost	(5,056)	(4,839)
Interest and Dividends on Investments	36,078	31,817
Net Cash Provided by (Used in) Investing Activities	29,104	21,948
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,056	8,767
CASH AND CASH EQUIVALENTS - JULY 1	25,897	17,130
CASH AND CASH EQUIVALENTS - JUNE 30	$ 29,953	$ 25,897

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - NEW FUND
STATEMENTS OF CASH FLOWS
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net Income (Loss)	$ (6,099)	$ 2,111
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used in) Operating Activities		
Depreciation	288	253
Amortization	987	345
Security Lending Income	(5,371)	(4,944)
Security Lending Cost	5,207	4,734
Interest on Investments	(18,787)	(17,811)
Decrease (Increase) in		
Accounts Receivable	(39)	(3,647)
Due From Other Funds	1,306	(142)
Inventories	6	8
Deferred Acquisition Costs	(171)	-
Other Assets	395	(369)
Increase (Decrease) in		
Accounts payable	155	205
Due to Other Funds	246	54
Deferred Revenue	(4,721)	3,905
Property Held in Trust	575	(44)
Estimated Claims	11,400	(7,187)
Compensated Absences	83	113
Total Adjustments	(8,441)	(24,527)
Net Cash Used in Operating Activities	$ (14,540)	$ (22,416)

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - OLD FUND
BALANCE SHEETS
The State Fund is a component unit of the State of Montana
AS OF JUNE 30

ASSETS

	(in thousands) 2000	(in thousands) 1999
Cash in Treasury	$ 3,247	$ 159
Short-Term Investment Pool (Note 1)	5,733	8,511
Account Receivable (Note 1)	986	1,451
Allowance for Doubtful Accounts (Note 1)	(203)	(282)
Due From Other Funds (Note 1)	11	430
Interest Receivable (Note 1)	1,586	1,643
Long-Term Securities (Notes 1 and 2)	126,378	133,241
Cash Collateral - Securities on Loan (Note 1)	5,317	6,462
Other Assets	17	124
Total Assets	$ 143,072	$ 151,739

LIABILITIES AND FUND EQUITY

	2000	1999
Liabilities		
Estimated Claims Liability (Discounted) (Note 4)	$ 117,945	$ 130,064
Liability for Securities on Loan	5,317	6,462
Deferred Revenue	656	434
Due to Other Funds (Note 5)	501	289
Other Liabilities	93	113
Total Liabilities	124,512	137,362
Fund Equity		
Contributed Capital	154,468	154,468
Unrestricted Retained Earnings	(135,908)	(140,091)
Total Fund Equity	18,560	14,377
Total Liabilities and Fund Equity	$ 143,072	$ 151,739

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - OLD FUND
STATEMENTS OF OPERATIONS AND CHANGES IN FUND EQUITY
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
UNDERWRITING RESULTS		
Premium	$ -	$ (87)
Claims Expenses		
Compensation Benefits Paid	5,886	6,734
Medical Benefits Paid	7,244	5,953
Allocated Loss Adjustment Expenses	291	336
Changes in Actuarially Estimated Claims (Discounted)	(12,119)	(64,337)
Other Expenses		
Old Fund Administration Cost Allocation	1,146	821
Taxes, assessments and other	407	288
Underwriting Gain (Loss)	(2,855)	50,118
Old Fund Liability Tax Revenue	1,892	28,891
Investment Income	8,545	8,300
Net Increase (Decrease) in the Fair Value of Investments	(3,413)	(2,367)
Security Lending Income (Note 1)	410	332
Security Lending Expense (Note 1)	(396)	(312)
NET INCOME	4,183	84,962
FUND EQUITY - Beginning of Year	14,377	(70,585)
FUND EQUITY - End of Year	$ 18,560	$ 14,377

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND - OLD FUND
STATEMENTS OF CASH FLOWS
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for Sales and Services	$ -	$ (17)
Payments to Suppliers for Goods and Services	(1,362)	(2,440)
Payment to Employees	-	(190)
Cash Payments for Claims	(13,421)	(12,990)
Collections of Notes Receivable	-	2
Other Operating Revenues	3,028	31,003
Net Cash Provided by (Used in) Operating Activities	(11,755)	15,368
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Payment of Principal and Interest on Bonds and Notes	-	-
Contributed Capital from net Fund	-	-
Residiual Equity Transfer - New Fund	-	-
Loss on Debt Extinguishment	-	-
Net Cash Provided by (Used in) NonCapital Financing Activities	-	-
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Investments	(13,332)	(53,560)
Proceeds from Sales or Maturities of Investments	16,762	29,299
Securities Lending Income	410	301
Securities Lending Expense	(396)	(283)
Interest and Dividends on Investments	8,621	8,234
Net Cash Provided by (Used in) Investing Activities	12,065	(16,009)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	310	(641)
CASH AND CASH EQUIVALENTS - July 1	8,670	9,311
CASH AND CASH EQUIVALENTS - June 30	$ 8,980	$ 8,670

The accompanying notes are an integral part of these financial statements.

MONTANA STATE FUND- OLD FUND
STATEMENTS OF CASH FLOWS
The State Fund is a component unit of the State of Montana
FOR THE YEARS ENDED JUNE 30

	(in thousands) 2000	(in thousands) 1999
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	$ 4,183	$ 84,962
Adjustments to Reconcile Operating Income to Net Cash Provided by (Used in) Operating Activities		
Interest on Investments	(5,132)	(5,933)
Securities Lending Expense	396	312
Securities Lending Income	(410)	(332)
Decrease (Increase) in		
Accounts Receivable	386	1,869
Due From Other Funds	419	88
Other Assets	108	(124)
Increase (Decrease) in		
Accounts Payable	-	18
Due to Other Funds	212	(1,356)
Deferred Revenue	222	176
Estimated Claims	(12,119)	(64,337)
Other Liabilities	(20)	25
Total Adjustments	(15,938)	(69,594)
Net Cash Used in Operating Activities	$ (11,755)	$ 15,368

The accompanying notes are an integral part of these financial statements.

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (State Fund) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). The State Fund provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. The State Fund is governed by a seven member Board of Directors appointed by the Governor. The State Fund is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund.

The New Fund functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of the New Fund are separate and distinct from assets, debts, and obligations of the State of Montana. Upon dissolution of the New Fund, any monies not needed to liquidate the New Fund would be subject to legislative provision according to state law (Section 39-71-2322, MCA). The State Fund administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see note 4, Old Fund). No State general fund money is used for State Fund operations.

Because of the Governor's appointment of the board members and the state's regulatory oversight function, the State Fund financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report.

Basis of Accounting

The State Fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, the State Fund records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

<u>Cash and Short Term Investment Pool</u>

Cash balances include demand deposits with the State Treasury. The State Fund also participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. There are no legal risks that the Board of Investments is aware of regarding any STIP investments. The market value of STIP approximates cost. The New Fund STIP balance of $27,517,152 as of June 30, 2000 represented 2.04% of the total STIP. The Old Fund STIP balance of $5,733,096 as of June 30, 2000 represented 0.43% of the total STIP. The New Fund STIP balance of $25,450,599 as of June 30, 1999 represented 2.02% of the total STIP. The Old Fund STIP balance of $8,511,322 as of June 30, 1999 represented 0.67% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Board of Investment's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The six NRSRO's include Standard and Poors, Moody's, Duff and Phelps, Fitch, International Bank Credit Agency and Thompson's Bank Watch.

Asset-backed securities constituted 28.86% of the Board of Investment's total STIP portfolio as of June 30, 2000. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constituted 21.64% of the Board of Investment's total STIP portfolio as of June 30, 1999.

Variable rate (Floating Rate) securities made up 4.68% of the Board of Investment's total STIP portfolio as of June 30, 2000. Variable rate securities made up 26.64% of the Board of Investment's total STIP portfolio as of June 30, 1999. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Long-Term Securities

The State Fund invests monies with the Montana Board of Investments, including STIP amounts. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools" (GASB 31). Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

State Fund investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered and held by the Board of Investments or its agent in the Board's name. Not Categorized includes investments held by broker-dealers under loans with cash collateral. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities.

Under the provisions of state statutes, the State Board of Investments has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend the Board's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the Board's custodial bank on December 1, 1993. During the period the securities are on loan, the Board receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than one hundred percent of the market value of the loaned security. The Board retains all rights and risks of ownership during the loan period.

During fiscal years 1999-00 and 1998-99, State Street loaned, on behalf of the Board, certain securities held by State Street, as custodian, and received U.S. dollar currency cash, U.S. Government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The Board did not impose any restrictions during fiscal years 2000 and 1999 on the amount of the loans that State Street made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2000 and 1999. There were no losses during fiscal years 2000 and 1999 resulting from default of the borrowers or State Street.

During fiscal years 1999-00 and 1998-99, the Board of Investments and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the Board's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the Board could not determine. On June 30, 2000 and June 30, 1999, the Board had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years 1999-00 and 1998-99 for both the New Fund and the Old Fund:

	NEW FUND		OLD FUND	
	Fiscal Year 1999-00	Fiscal Year 1998-99	Fiscal Year 1999-00	Fiscal Year 1998-99
Securities on Loan-Book Value	$94,981,807	$83,897,929	$5,219,966	$5,789,105
Securities on Loan-Market Value	$96,497,807	$87,466,456	$5,182,304	$5,833,184
Total Collateral Held	$100,180,241	$91,728,271	$5,317,362	$6,462,317

As of June 30, 2000, investments in the New Fund and the Old Fund include $94,981,807 (approximately 22.5 % of total long-term securities), and $5,219,966 (approximately 4.1% of total long-term securities), respectively, in long-term securities on loan which earned interest income during the fiscal year of $5,370,971 and $410,454, respectively.

As of June 30, 1999, investments in the New Fund and the Old Fund include $83,897,929 (approximately 19.8% of total long-term securities), and $5,789,105 (approximately 4.3% of total long-term securities), respectively, in long-term securities on loan which earned interest income during the fiscal year of $4,943,583 and $332,198, respectively.

Montana's Constitution does not currently allow the State Fund to invest in equity securities.

Receivables

The New Fund premium receivable balance of $11.9 million at June 30, 2000 includes $4.6 million of premium due from insureds for insurance coverage provided during fiscal year 1999-00 not yet received. The remaining $7.3 million represents advance premiums billed but not received for insurance coverage effective July 1, 2000 as part of the State Fund's Premium in Advance program. This amount is offset in deferred revenue. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $394,476. Other receivables include $6.988,996 million in investment income due, and $491,179 million due from other state agencies and funds.

The New Fund premium receivable balance of $14.995 million at June 30, 1999 includes $4.4 million of premium due from insureds for insurance coverage provided during fiscal year 1998-99 not yet received. The remaining $10.5 million represents advance premiums billed but not received for insurance coverage effective July 1, 1999 as part of the State Fund's Premium in Advance program. This amount is offset in deferred revenue. Estimated uncollectible receivables are reported as an allowance for doubtful accounts of $394,476. Other receivables include $6.4 million in investment income due, and $1.9 million due from other state agencies and funds.

Accounts receivable in the Old Fund includes amounts due from past premiums in dispute or in collection and amounts due from Old Fund Liability Tax collections. Interest receivable of $1.6 million represents investment income due. Estimated uncollectible receivables are reported as an allowance for doubtful accounts.

Fixed Assets

Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Depreciation expense is computed on a straight-line basis for equipment over a period of five to ten years. Amortization of intangible assets is computed on a straight-line basis over a period of three to seven years and is applied directly to the asset balance. All fixed assets are recorded in the New Fund. Because the State Fund administers the Old Fund, the Old Fund does not carry fixed assets.

Advanced Deposits

Security deposits are deposits by certain policyholders that secure payment of premiums.

Deferred Revenue

Deferred revenue reflect amounts in advance that are received or billed, but not yet earned for policies effective July 1, 2000 or July 1, 1999.

Premiums

The State Fund Board of Directors approves premium rates annually. Policies are effective for the term of the policy period not to exceed 12 months. Revenue from premiums is recognized over the term of the fiscal year, which runs from July 1 through June 30.

Policyholders are contractually obligated to pay certain premiums to the State Fund in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by the State Fund.

Fund Equity

Fund Equity consists of the net excess or deficit of assets over liabilities.

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State Fund insurance operations are classified as an Enterprise Fund, Proprietary Fund type.

The Enterprise Fund of the State Fund is part of, but does not comprise, the entire Enterprise Fund of the State of Montana. The financial statements in this report reflect the financial position and results of operations and cash flows of the Montana State Fund (New Fund and Old Fund), not the State of Montana.

The Enterprise Fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

According to GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools, STIP is considered an external investment pool. An external investment pool is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The Board of Investments has adopted a policy to treat STIP as a 2a7-like pool.

As a governmental entity, the State Fund is required to follow rules promulgated by the Governmental Accounting Standards Board. A private insurance carrier reporting under GAAP accounting rules would follow Financial Accounting Standards Board Statement 115 (FASB 115) as their guideline in reporting changes in market values of investments held to maturity. The State Fund holds its investments to maturity and as such followed FASB 115 prior to the implementation of GASB 31.

A comparison of the GASB 31 and FASB 115 treatments on the New Fund financial statements for fiscal year 1999-00, under a held-to-maturity classification of investments, reveals:

	GASB 31	FASB 115
Underwriting gain (loss)	\$(18,074,678)	\$(18,074,678)
FY00 market valuation effect	(11,457,794)	-
Other investment income	30,409,058	30,409,058
Dividend expense	(6,950,716)	(6,950,716)
Operating transfers out	-	-
Other income (expense)	11,603	11,603
Net income (loss)	(6,062,526)	5,395,267
Beginning surplus	144,363,233	141,776,815
Prior year adjustment	-	-
Ending surplus – June 30, 2000	\$ 138,300,707	\$147,172,082

See Note 2 for further discussion of the effect of GASB 31.

2. Investments

The amortized cost and market value of the New Fund fixed maturity securities as of June 30, 2000, and June 30, 1999, are as follows:

		Gross Unrealized		
June 30, 2000	Amortized Cost	Gains	Loss	Market Value
U.S. Treasury Securities	$ 84,160,568	$ 2,000,562	$ 273,450	$ 85,887,680
U.S. Government Agencies and U.S. Government Guaranteed Securities	83,066,242	648,088	3,308,876	80,405,454
Corporate Securities Asset Backed	41,384,510	-	332,950	41,051,560
Other Corporate Securities	193,747,019	691,161	7,615,252	186,822,928
Other Securities	18,945,340	-	680,660	18,264,680
STIP	27,517,152	-	-	27,517,152
Total	$448,820,831	$ 3,339,811	$12,211,188	$439,949,454

		Gross Unrealized		
June 30, 1999	Amortized Cost	Gains	Loss	Market Value
U.S. Treasury Securities	$ 91,926,186	$ 3,756,754	$ -	$ 95,682,940
U.S. Government Agencies and U.S. Government Guaranteed Securities	57,435,349	413,175	1,095,049	56,753,475
Corporate Securities Asset Backed	54,346,938	311,625	319,394	54,339,169
Other Corporate Securities	205,637,445	2,678,518	3,225,832	205,090,131
Other Securities	11,000,850	84,034	17,414	11,067,470
STIP	25,450,599	-	-	25,450,599
Total	$445,797,367	$ 7,244,106	$ 4,657,689	$448,383,784

The amortized cost and estimated market value of the New Fund's fixed maturity securities as of June 30, 2000 and June 30, 1999, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2000

	Amortized Cost	Market Value
Due one year or less	$ 39,179,405	$ 39,046,002
Due after one year through five years	241,527,623	237,382,893
Due after five years through ten years	111,800,321	109,761,039
Due after ten years	56,313,482	53,759,520
Totals	$448,820,831	$439,949,454

June 30, 1999

	Amortized Cost	Market Value
Due one year or less	$ 35,449,536	$ 35,527,599
Due after one year through five years	172,447,998	174,386,666
Due after five years through ten years	185,305,816	187,854,025
Due after ten years	52,594,017	50,615,494
Totals	$445,797,367	$448,383,784

During fiscal year ending June 30, 2000, the New Fund realized gross gains from sales of securities of $639,917 and gross realized losses of $299,798. During fiscal year ending June 30, 1999, the New Fund realized gross gains from sales of securities of $601,763 and gross realized losses of $22,729.

As discussed in Note 1, GASB 31 requires governmental entities to state their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 1999-00, investment income for the New Fund was adjusted downward $11.4 million due to the unrealized loss on long-term investments. Investment income for fiscal year 1998-99 was adjusted downward $12.4 million for the unrealized gain which occurred during that year on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2000 and June 30, 1999 are as follows:

		Gross Unrealized		
June 30, 2000	Amortized Cost	Gains	Loss	Market Value
U.S. Treasury Securities	$ 5,049,160	$ -	$ 33,560	$ 5,015,600
U.S. Government Agencies and U.S. Government Guaranteed Securities	30,271,942	-	1,202,653	29,069,289
Government Mortgage-Backed	18,442,532	-	955,245	17,487,289
Corporate Securities Asset Backed	30,010,291	4,113	415,946	29,598,458
Other Corporate Securities	41,140,162	12,983	2,588,862	38,564,283
Other Securities	7,013,025	-	369,665	6,643,360
STIP	5,733,096	-	-	5,733,096
Total	$137,660,208	$ 17,096	$ 5,565,931	$132,111,373

		Gross Unrealized		
June 30, 1999	Amortized Cost	Gains	Loss	Market Value
U.S. Treasury Securities	$ 5,076,095	$ 53,605	$ -	$ 5,129,700
U.S. Government Agencies and U.S. Government Guaranteed Securities	44,858,131	-	973,688	43,884,443
Corporate Securities Asset Backed	40,080,638	30,169	329,086	39,781,721
Other Corporate Securities	43,456,686	19,115	1,017,596	42,458,205
Other Securities	1,996,884	-	10,444	1,986,440
STIP	8,511,322	-	-	8,511,322
Total	$143,979,756	$ 102,889	$ 2,330,814	$141,751,831

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2000 and June 30, 19[illegible] are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrow[illegible] may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2000

	Amortized Cost	**Market Value**
Due one year or less	$ 7,387,670	$ 7,374,407
Due after one year through five years	82,250,628	79,120,907
Due after five years through ten years	29,465,834	28,187,888
Due after ten years	18,556,076	17,428,171
Totals	$137,660,208	$132,111,373

June 30, 1999

Due one year or less	$ 10,514,620	$ 10,515,042
Due after one year through five years	56,795,902	56,272,970
Due after five years through ten years	46,022,894	45,204,499
Due after ten years	30,646,339	29,759,320
Totals	$143,979,755	$141,751,831

During fiscal year 1999-00, investment income for the Old Fund was decreased $3,320,910 due to the unrealized loss on its long-term portfolio. During fiscal year 1998-99, the effect of GASB 31 on Old Fund investment income was an increase of $2,396,589.

During fiscal year ended June 30, 2000, the Old Fund realized $17,286 in gross gains from sales of securities and gross realized losses of $109,150. During fiscal year ended June 30, 1999, the Old Fund realized $30,392 in gross gains from sales of securities and no gross realized losses.

3. Reinsurance

For the two fiscal years ended June 30, 2000 the State Fund ceded reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against losses over stipulated amounts and an aggregate stop loss contract covering fiscal year 1999-00. During fiscal years 1998-99 and 1999-00, the State Fund retained the first $1.5 million of each loss and for the year 1998-99 respectively, $500,000 and $750,000 in aggregate annual deductible, while reinsurers were liable for losses in excess of $2 million (FY99) and $2.25 million (FY00) up to a limit of $50 million on occurrences involving multiple claimants. Individual, per person coverage was provided up to $5 million per claimant with the State Fund retaining the first $2.5 million. This per person coverage is subject to an annual limit of $10 million. In the event, reinsurers are unable to meet their obligations; the State Fund would remain liable for all losses, as the reinsurance agreements do not discharge the State Fund from its primary liability to the policyholders.

The State Fund purchased reinsurance coverage for Employers' Liability insurance offered to policyholders during fiscal years 1998-99 and 1999-00. The State Fund retains the first $200,000 in ultimate net loss for any one occurrence while reinsurers are liable for losses in excess of $200,000 up to a limit of $1 million.

Effective January 1, 1999 the State Fund purchased reinsurance coverage for Out of State insurance offered to policyholders effective January 1, 1999. The coverage extends to January 1, 2000. The State Fund will retain the first $250,000 in ultimate net loss for each loss occurrence while the reinsurers are liable for losses in excess if $250,000 up to a limit of $5 million.

Premium revenue is reduced by premiums paid for reinsurance coverage of $855,204 and $259,498 in fiscal years 1999-00 and 1998-99, respectively.

During fiscal year 1998-99 and 1999-00, estimated claim reserves were reduced $15 million and $7 million, respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

4. Risk Management/Public Entity Risk Pool

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socioeconomic factors.

The New Fund provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At June 30, 2000, approximately 23,481 employers were insured by the New Fund. At June 30, 1999, approximately 23,269 employers were insured by the New Fund. Anticipated investment income is considered when computing premium rate levels and employers must pay premiums to the State Fund within specified time frames.

Tillinghast-Towers Perrin prepared an actuarial study and estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported for the New Fund as of June 30, 2000 and June 30, 1999. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2000, $314,900,000 of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable. As of June 30, 1999, $303,500,030 of unpaid claims and claim adjustment expenses are presented at face value. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of the New Fund is terminated.

State law requires the New Fund to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires the State Fund to establish a minimum surplus balance of 25% of annual premium revenue.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments is provided by Old Fund Liability Taxes (OFLT) imposed on employer payroll (0.5%), employee wages (0.2%), and sole proprietor and subchapter S shareholder distributive income (0.2%). The OFLT provides funding for Old Fund claim expenses and Old Fund bond payments (see notes 5 and 12).

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2000, was used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported. As of June 30, 2000, $167,915,000 of unpaid claims and unpaid claim

adjustment expenses are presented at their net present value of $117,945,000, discounted at a 5.5% rate As of June 30, 1999, $185,064,668 of unpaid claims and unpaid claim adjustment expenses are presented at their net present value of $130,063,841. Total Old Fund surplus as of June 30, 2000 is $18,573,293 compared to $14,376,735 as of June 30, 1999.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes (in thousands) in the aggregate liabilities for the New Fund and the Old Fund for the past two years net of estimated reinsurance recoverable. The information presented has not been discounted.

	New Fund		Old Fund	
	2000	1999	2000	1999
Unpaid claims and claim adjustment expenses at beginning of year	$303,500	$ 310,687	$185,064	$ 194,401
Incurred claims and claim adjustment expenses:				
Provision for insured events of the current year	74,445	69,390	-	-
Increase (decrease) in provision for events of prior years	(6,049)	(15,791)	(3,728)	3,686
Total incurred claims and claim adjustment expenses	68,396	53,599	(3,728)	3,686
Payments:				
Claims and claim adjustment expenses attributable to insured events of the current year	(13,177)	(14,878)	-	-
Claims and claim adjustment expenses attributable to insured events of prior years	(43,856)	(45,908)	(13,421)	(13,023)
Total Payment	(57,033)	(60,786)	(13,421)	(13,023)
Total unpaid claims and claim adjustment expenses at end of year	$314,863	$ 303,500	$167,915	$ 185,064

Risk Management Trend Information

The following table illustrates (in thousands) how the earned revenues of the New Fund plus investment income compare to related costs of loss and other expenses assumed by the State Fund for fiscal years 1992 through 2000. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2000 and 1999

New Fund	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
1. Premiums and Investment Revenue										
Earned	$117,443	$159,499	$210,725	$227,455	$186,580	$130,898	$98,610	$83,345	$73,625	$69,388
Ceded	231	270	289	318	269	519	348	303	260	855
Net Earned	$117,212	$159,229	$210,436	$227,137	$186,311	$130,379	$98,262	$83,042	$73,365	$68,533
2. Unallocated expenses including overhead	9,567	6,663	7,924	9,046	15,147	18,234	13,454	15,266	20,355	24,823
3. Estimated losses and expenses, end of accident year										
Incurred	$133,819	$183,425	$186,480	$199,890	$164,628	$95,067	$76,067	$64,983	$64,645	$65,957
Ceded	0	0	0	0	0	0	0	0	838	0
Net Incurred	$133,819	$183,425	$186,480	$199,890	$164,628	$95,067	$76,067	$64,983	$63,807	$65,957
4. Net paid (cumulative) as of:										
End of policy year	17,618	20,244	18,347	18,693	18,137	15,818	12,589	12,943	13,723	13,177
One year later	44,335	50,576	46,343	45,947	40,473	32,890	28,451	28,222	29,976	
Two years later	64,079	68,837	62,717	60,971	52,073	42,361	35,706	35,753		
Three years later	74,901	77,950	71,666	67,576	58,722	47,283	39,860			
Four years later	81,747	83,173	76,280	72,212	62,419	50,267				
Five years later	85,924	86,461	80,165	75,799	65,919					
Six years later	88,532	89,370	82,981	78,306						
Seven years later	91,235	91,903	85,357							
Eight years later	93,381	94,131								
Nine years later	95,699									
5. Re-estimated ceded losses and expenses	0	0	0	0	0	1,183	3,521	1,414	882	0
6. Re-estimated net incurred losses and expense:										
End of policy year	$133,819	$183,425	$186,480	$199,890	$164,628	$95,067	$76,067	$64,983	$63,807	$65,957
One year later	166,980	184,968	184,030	184,920	124,123	88,923	67,235	64,308	64,348	
Two years later	160,272	175,218	167,052	135,472	107,074	77,286	59,054	60,467		
Three years later	151,554	161,184	133,017	116,756	95,456	73,864	60,811			
Four years later	141,389	135,775	120,583	107,656	94,517	74,022				
Five years later	130,250	125,084	111,208	105,052	92,231					
Six years later	121,568	119,780	109,415	106,039						
Seven years later	118,856	120,472	111,638							
Eight years Later	118,948	120,397								
Nine years later	118,489									
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	(15,330)	(63,028)	(74,842)	(93,851)	(72,397)	(21,045)	(15,256)	(4,516)	541	0

5. Administrative Cost Allocation

State law requires the State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25 million for Fiscal year 1999-00 and $1.25 million for fiscal year 1998-99. The State Fund allocated $1.25 million and $1.25 million in administration costs to the Old Fund in fiscal years 1999-00 and 1998-99, respectively. The Old Fund has a $598,452 obligation to the New Fund in unrecovered administrative costs incurred in fiscal years 1998-99 and 1999-00. The New Fund intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25 million.

6. New Fund Surplus Distributions

i. Dividend Paid to Policyholders

During Fiscal Year 1999-00, the State Fund Board of Directors authorized a dividend be paid to policyholders of record during fiscal year 1998. The dividend payment was not to exceed $7 million in aggregate as recommended by the consulting actuary, Tillinghast-Towers Perrin.

Payment of the dividend totaling $7 million was accomplished during March 2000.

ii. Payment to State General Fund

Section 39-71-2320 (2) MCA provides for the payment of $10 million by the New Fund to the State's General Fund in each of the fiscal years ending June 30, 1998 and June 30,1999. When completed, this will repay in full the $20 million appropriation made to the Old Fund during the June 1989 Special Legislative Session in lieu of a 22% rate increase originally planned at that time.

The final payment was accomplished in fiscal year ending June 30, 1999 for $10 million. The 1998-99 payment is reflected in the financial statements as an operating transfer out.

7. Old Fund Surplus Position

The Budget Director determined, based on the recommendation presented by the State Fund Board of Directors in September 1998, that the Old Fund Liability Tax could end on January 1, 1999 in compliance with State law.

Because the Old Fund was determined to be adequately funded as of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.5% to determine compliance with state law requirements for maintaining fund adequacy.

State law defines the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,
b) the cost of administering the claims; and,
c) an amount equal to 10% of the total of the amounts in subsections (a) and (b) above.

As of June 30, 2000 the Old Fund surplus level using a present value discount factor of 5.5% was $18,573,293. The 10% contingency required to be retained in excess of the full cost needed to cover the expense of the administration and payment of any unpaid claims equaled $11,794,500.

8. Compensated Absences

Employees at the State Fund accumulate both annual leave and sick leave. The State Fund pays employees for 100% of unused annual leave and 25% of unused sick leave upon termination. The fund pays 100% of unused compensatory leave credits upon termination to nonexempt employees. The State Fund absorbs expenditures for termination pay in its annual operational costs. The State Fund had a total leave liability of $990,278 and $907,249 at June 30, 2000 and 1999, respectively.

9. Pension Plan

The State Fund and its employees contribute to the Public Employees Retirement System (PERS), a mandatory multiple-employer, cost-sharing, defined benefit pension plan administered by the State of Montana Public Employees Retirement Division (PERD). The PERS offers retirement, disability and death benefits to plan members and their beneficiaries. Established in 1945, the plan is governed by Title 19, Chapters 2 and 3, MCA. PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. Actuarially reduced retirement benefits may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average salary. Vesting occurs once membership service totals 5 years. The authority to establish and amend contribution rates and to provide cost of living adjustments for the plan is assigned to the State legislature. State Fund and its employees each were required to contribute 6.8% of annual compensation in fiscal years 1998-99 and 6.9% of annual compensation in fiscal years 1999-00. This amounted to $1,093,978 for fiscal year 1999-00, $1,006,516 for fiscal year 1998-99. State Fund and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2000.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from the PERD at 1712 Ninth Avenue, P. O. Box 200131, Helena, MT 59620-0131, 406/444-3154.

10. Building

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. As of July 1, 1990, the State Fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the State Fund pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Contingencies

In prior years, the State Fund purchased single premium annuities from Confederation Life Insurance Company (the Company), Atlanta, Georgia to settle claims. The Company has been placed in bankruptcy rehabilitation by the Michigan Insurance Department. State Fund legal counsel has reviewed the rehabilitation plan (Plan) of Confederation Life Insurance Company. There were twelve Old Fund claims with annuities with the Company. The outstanding balances on the annuities amount to $234,753. The Plan anticipates full payment of annuity contracts. State Fund will continue to monitor the execution of the Plan.

Broeker v. State Fund. The issue in this case involved the method insurers use to calculate the social security disability insurance (SSDI) offset rates on certain claims. The Workers' Compensation Court decision stated that, where there is a cost of living increase built into the initial entitlement to social security disability benefits, the workers' compensation insurer cannot take the cost of living increase into consideration when computing the SSDI offset rate. On appeal, the Montana Supreme Court affirmed the Workers' Compensation Court decision. This decision potentially affects similarly situated claimants. Because we are just beginning to identify those claims, no calculation of total potential benefits due has been made. This matter is currently before the Workers' Compensation Court for implementation of the Supreme Court's decision.

Murer, et al. v. Montana State Compensation Mutual Insurance Fund, et al. This case involves the 1987 legislature's limiting of workers' compensation benefits for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature re-enacted those limits for injuries occurring during the period July 1, 1989 through June 30, 1991.

The Montana Supreme Court found that those limits should have expired on June 30, 1989 for injuries occurring during the period July 1, 1987 through June 30, 1989 and should have expired on June 30, 1991 for injuries occurring during the period July 1, 1989 through June 30, 1991.

The review process is near completion for approximately 7,500 claims in which the State Fund determined qualification for increased benefits due to expiration of the limits instituted by the 1987 and 1989 legislative sessions. Total cost impact is estimated to be between $1 million and $2 million. Individual case loss reserves are adjusted as liability is determined.

Michael Powell vs. State Fund This case involves the constitutionality of 39-71-1107(4), MCA, which places limits on compensation paid to family members providing domiciliary care to claimants. The State Fund prevailed in Workers' Compensation Court with a finding that current law does not violate the claimant's rights to equal protection and privacy. The issue has been appealed to the State Supreme Court. The potential cost impact, if any, has not yet been determined.

State Fund Response

MONTANA STATEFUND

5 South Last Chance Gulch • PO Box 4759 • Helena, MT 59604-4759
Customer Service 1-800-332-6102 or 406-444-6500
Fraud Hotline 1-800-682-7463 (800-MT-CRIME)

Carl W. Swanson, President/CEO

January 11, 2001

JAN 12 2001

Scott Seacat
Legislative Audit Division
PO Box 201705
Helena, Montana 59620-1705

Dear Scott:

The Montana State Fund extends our thanks to the Legislative Audit Division staff for their review of the Montana State Fund operations. We look to the audit review as a way of ensuring to our Montana State Fund (MSF) Board of Directors, our customers, our business partners, the Governor and the Legislature that we have the necessary financial credibility, strength, and ability to pay our ultimate liabilities over time, as determined by outside independent actuaries. Most important to us is the unqualified opinion of the Legislative Audit Division on the State Fund financial statements. We appreciate this conclusion over our financial condition. We believe it will assure legislators the State Fund recognizes its' fiduciary responsibilities to Montana businesses and is a well-managed organization under the strong leadership of our executive management team and our Board of Directors.

The Legislative Audit Division, as a result of their audit, has determined section 39-71-2363, MCA, is ambiguous with regard to the administrative expense limit and has recommended the Montana State Fund seek legislation to clarify and remove the ambiguity. We partially concur with the recommendation because we believe our current treatment is correct under the law. However, we agree that insofar as the Legislative Audit Division has arrived at the conclusion there is still ambiguity in the law and recommend we should seek clarification. As part of the 2001 Legislative Session the State Fund will seek to remove the administrative expense limit currently established, which with legislative support will resolve any clarity and ambiguity issues.

Our current treatment and application of the law is in our opinion consistent with legislative intent. Our application remains the same today as when the Chapter 276, Laws of 1997, was enacted allowing the MSF Board of Directors to utilize up to half of our investment income "earned" when calculating compliance with the administrative expense limit. Although we report financial statements to the State of Montana applying GASB 31, which became effective after the legislation was enacted, we calculate the administrative expense limit based on insurance industry accounting standards, which has always recognized "investment income earned." The GASB 31 standard only recognizes "investment income" and not "investment income earned," as the law, section 39-71-2363, MCA clearly states.

Our mission is to be Montana's insurance carrier of choice and industry leader in service.

Simply put, the law says, "investment income earned." We believe one must interpret compliance with what is in the law and the law clearly says, "earned". Under the GASB pronouncement, "investment income" would include changes in the fair value of the investments. These would be any "unrealized" gains and losses. Since these gains and losses have not been realized, they cannot be considered as "earned" as specified in the law. We also defer to court interpretation of statute and take the position that the plain meaning of the word controls and the court need not go further or apply any other means of interpretation. Phelps v. Hillhaven Corp. (1988), 231 Mont.245,251,752 P. 2d 737,741. More recently, in Sherner v. Conoco, Inc. (2000), the Supreme Court reaffirmed that language of a statute should be construed according to the plain meaning of the words used and that if statutory language is clear and unambiguous, then no further interpretation is needed. The word "earned" as used in the law is very clear.

If we were to apply GASB 31 and the resulting affects of it in determining compliance with the administrative expense limit portion of the law, it would introduce tremendous volatility in the business operations of the State Fund. For example, for the fiscal year ended June 30, 1998, the change in the fair value of investments was a positive of $12.5 million and on an "earned" basis investment income was $32.5 million. In fiscal year 1999, the change in the fair value of investments was a negative $11.9 million, but the "earned" investment income was $29.7 million. In fiscal year 2000, the change in the fair value of investments was another negative $11.1 million, but the "earned" investment income was $29.9 million. As you can see, there are wide fluctuations in the changes in fair value of our investments, while our earned investment income remained stable over the same period. We believe the Legislature seeks stability for the State Fund rather than creating a task of managing our operations around fluctuations in investment markets. It would be extremely difficult, if not impossible, to attract and retain skilled employees, and to keep pricing for our customers as low as possible in this volatile situation.

We believe there is no clear requirement that GASB 31 be utilized when calculating the administrative expense limit. Also, utilizing GASB 31 would change the method of calculating the expense limit that was understood by the Legislature when Chapter 276 was enacted in 1997. GASB 31 does not define investment income "earned", it only states the investment income revenue should include changes in the fair value of investments. Accounting treatment in the insurance industry does provide definition for investment income "earned." Our treatment remains consistent with the insurance industry literature, and we believe legislative intent when the law was passed.

We have referred accounting guidelines applicable to insurance organizations, which do address investment income earned to the Legislative Audit Division as support for defining "earned" investment income. These guidelines would also apply to the Montana State Fund, as a worker's compensation insurer operating in a competitive market in Montana. Some of these accounting guidelines are:

- The National Association of Insurance Commissioners (NAIC), Statement of Statutory Accounting Principles (SSAP) number 26 states, "...bonds that are

- designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; with all other bonds (NAIC designations 3 to 6) reported at lower of amortized cost or fair market value." The securities held by the Montana State Fund are all in the NAIC designation 1 and 2, which would have the State Fund report the assets at amortized cost on the statutory accounting statements. The statement goes on to describe interest income for any period to include interest collected plus the change in due and accrued interest between the beginning and the end of the period. Interest income as provided in SSAP 26 does not include change in the fair value of the assets.

- The Financial Accounting Standards Board (FASB) statement 115 titled, "Accounting for Certain Investments in Debt and Equity Securities," provides that an entity classify their investments as:

  - Held to maturity if investments in fixed income or debt securities are fully intended and there is the ability to hold the investment to the maturity date. These investments are measured at their amortized cost. The long-term fixed income securities owned by the State Fund are purchased with the intent of holding the instruments to maturity.
  - Trading securities where the intent is to see the security and trading reflects active and frequent buying and selling. Any unrealized gains and losses shall be included in earnings.
  - Available for sale that would be the investments not classified as trading or held to maturity. The unrealized gains and losses on these investments would be excluded from earnings and reported as an adjustment to surplus.

Our purpose is to point out that there is other accounting guidance for treatment of the changes in the fair value of invested assets and we disagree with the statement in the audit report section that, "it appears that the meaning of the term investment income earned changed since the passage of Chapter 276, laws of 1997." It would be just as appropriate to apply other accounting standards to the law as it would to apply GASB 31 to the law. As an insurance organization, we should apply insurance accounting standards.

The report indicates state law does not define the term "investment income earned." The term is also not defined in GASB 31. GASB 31 states, "All investment income, including changes in the fair value of investments should be recognized as revenue in the operating statement." However, GASB 31 does not state this should be considered earned, only that it should be included as revenue. Insurance accounting literature, however, provides separate definitions of "net investment income", Realized capital gains and losses" and "Unrealized capital gains and losses". They are not considered as all inclusive to investment income. In fact, net investment income is defined as investment income earned during the year less investment expenses.

The Legislative Audit Division Report also notes that we exclude the Old Fund investment income and the Old Fund administrative expenses in the determination of compliance with section 39-71-2363, MCA. Our position would be that a different section of law clearly addresses the administrative expense limit in the Old Fund, therefore, does not apply to determining compliance with this section. Section 39-71-2352, MCA, separately establishes the administrative expense limits for the Old Fund.

As noted above, during the 2001 Legislative Session, the State Fund will seek to remove the administrative expense limits established in law. The State Fund operates in a competitive environment where this market and the dramatic changes that can occur will require the State Fund to respond quickly to these market changes while operating efficiently and in a cost effective manner. More importantly, the State Fund Board of Directors consists of successful business people from around the state. Our Board has a fiduciary responsibility toward the best long term interest of employers we serve in Montana. They oversee our operations to ensure our expense levels remain competitive, are appropriate, our staffing levels meet the needs of our operations and customers, and we remain responsible in our management of the State Fund. We believe these are the controls needed to manage expense levels for the State Fund. Eliminating the administrative expense limits would remove the ambiguity in the law, as recommended by LAD.

Thank you for the review of the operations of the State Fund and for the opportunity to respond to the recommendation contained in the report.

Sincerely,

Carl Swanson

Carl Swanson
President/CEO